Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted]:POSTF-153561-01
[redacted]

date: December 21, 2001

to: [redacted], Group Manager
Internal Revenue Service (LMSB), [redacted]
Att: [redacted], Revenue Agent

from: Associate Area Counsel (LMSB), [redacted]

subject: [redacted]

DISCLOSURE STATEMENT

This memorandum supplements our advisory memorandum dated October 18, 2001, regarding the above taxpayer. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

DISCUSSION

In our previous memorandum, we advised you that:

1. Gross contract amounts collected under the terms of certain contracts entered into between [redacted] ([redacted]) and various non-employee doctors do not constitute gross income of [redacted] pursuant to I.R.C. § 61; and

2. [redacted] is exempt from the alternative minimum tax pursuant to the exemption for small corporations set forth at I.R.C. § 55(e).

As a result of the National Office review of that memorandum, this memorandum modifies our earlier advice. The above conclusions remain unchanged, but the basis for our opinion in item 1. above is amended as discussed below.

Previously, we founded our conclusion that the funds at issue did not constitute gross income of [redacted] on the claim of right doctrine. Upon further consideration, we withdraw our reliance on that doctrine in this case. Rather, we reach the same result on the grounds that [redacted] was serving as an agent or temporary custodian with respect to the portion of the total fee

paid over to the doctors. As to these funds, [redacted] was acting as the doctor's collection agent. These funds, even when in [redacted]'s possession, belonged to the doctors. Such funds were not [redacted]'s and are not included in its gross income. See A.J. Al-Hakim, T.C. Memo. 1987-136 (a sports agent need only include the portion of the bonus payment received which he was not obligated to turn over to his client); Melbourne Ranches, Inc. v. Commissioner, T.C. Memo. 1971-264 (corp. taxable on only half of gain from sale of lease where it proved that the lease was a joint venture); see also, Stevens Brothers & Miller-Hutchinson Co. v. Commissioner, 24 T.C. 953 (1955), acq. 1956-2 C.B. 8, and Mill v. Commissioner, 5 T.C. 691 (1945), acq. 1945 C.B. 5 (cases in which a "conduit" theory was applied in concluding that a taxpayer was not taxable on income turned over to a third party pursuant to a pre-existing agreement).

We reach this conclusion based on the specific facts of this case gleaned from our discussions with the Revenue Agent and from our examination of documents in the file. Among the facts that we find persuasive are the following:

1. The contracts between [redacted] and the doctors describe [redacted]'s obligation to "collect and promptly pay the professional component of the global patient fee" to the participating doctors. This description suggests to us that the "global patient fee" is an aggregate of separate fees, including the doctors', which [redacted] would centrally collect on behalf of the doctors.

2. The relationship between the doctors and [redacted] appears to be in the nature of a joint venture, rather than an employer/employee or independent contractor relationship. The division of the global patient fee represents the joint venturer's respective interests in the venture. The accounting records support this interpretation of the arrangement. The doctors who perform the surgeries have no right to payment in the event [redacted] is unable to collect from the patient. [redacted] and the doctors both bear the risk of nonpayment with respect to their portions of the global fee. This would not be the case if the doctors were merely employees or independent contractors of [redacted].

3. According to the agent, the customers remain patients of their respective doctors, even after they are referred to [redacted] for the surgery. [redacted] provides facilities, equipment, and certain services, and the doctors performs the surgeries and continue to treat the patients.

4. By the agreements with [redacted], the doctors retained the right to direct how and to whom the doctors' fees would be

distributed.

5. In addition, from interviews and experience in the industry, the Revenue Agent has advised us that, regardless of any ambiguities in the documents, [redacted]'s actual relationship with the participating doctors with respect to the global fee was that of collection agent. We have seen nothing in the file which contradicts this, and we accept it as fact.

Please place a copy of this memorandum in the administrative file. If you have any questions, please call me at [redacted].

[redacted]
Associate Area Counsel (LMSB)

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted]:POSTF-153561-01
[redacted]

date: 18 OCT 2001

to: [redacted], Group Manager
Internal Revenue Service, LMSB [redacted]
Attn: [redacted], Revenue Agent

from: [redacted]
Attorney (LMSB)

subject: [redacted]

DISCLOSURE STATEMENT

This memorandum is in response to your request for advice dated September 27, 2001. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUES

1. Whether the gross contract amounts collected under the terms of certain service contracts entered into between [redacted] and various non-employee doctors constitutes gross income of [redacted] pursuant to I.R.C. § 61.

2. Whether, [redacted] is exempt from the alternative minimum tax pursuant to the exemption for small corporations set forth at I.R.C. § 55(e).

CONCLUSION

1. No. Under the terms of the contract a portion of the fee collected is income to the non-employee doctor. [redacted] has no claim of right to the non-employee doctor's portion of the fee and therefore, this amount is excluded from the gross income of [redacted] and included in the gross income of the non-employee doctor.

2. Yes. [redacted] meets the gross receipts test of sections 55(e) and 448(c) so it is exempt from the application of the alternative minimum tax. The gross income attributable to the non-employee doctors is not included in the gross receipts of [redacted] since these receipts are not properly recognized by [redacted] under its method of accounting during any taxable year. [redacted] has no ownership interest in any of the entities owned by the non-employee doctors that would permit the aggregation of gross receipts under Treas. Reg. 1.448-1T(f)(2)(ii).

FACTS

[redacted] ([redacted]) is a C corporation and files a U.S. Consolidated Return of Income, Form 1120. [redacted] owns a [redacted]% or more interest in three LLCs [redacted], [redacted] and [redacted] ("[redacted] affiliates"). [redacted] reports its share of income attributable to the [redacted] affiliates. [redacted] owns various vision centers located throughout the United States. [redacted] uses the accrual method of accounting. A doctor is needed at every vision center owned by [redacted] to perform the laser eye surgery procedure using the machines owned by [redacted]. The doctors are not employees of [redacted]. [redacted] and the doctor execute a contract and agree to share fees with respect to the patients who choose to have the laser eye procedure. An example of a typical contract is attached as **Exhibit A.**

Generally, a typical contract calls for the parties to split fees. The fee for an eye procedure is collected by either [redacted] or the [redacted] affiliate and is divided between [redacted], the [redacted] affiliate and the doctor, as provided for in the contract. The sample contract which is attached as **Exhibit A** is between [redacted] (referred to as "[redacted]") and [redacted] and [redacted] (referred to as "MD" or "MD entity") and provides, in relevant part:

> Professional Fee - [redacted] shall collect a global fee for each laser procedure performed by MD, [redacted], MD, (so long as [redacted] shall remain a full-time employee or partner of the MD) and any full-time doctor employee or partner of MD who is not currently performing laser vision correction at a [redacted], and pay to MD and [redacted] and/or such other doctor an amount equal to [redacted]% of the net global fee collected by [redacted] with respect to such procedures. [redacted] shall pay a portion of such [redacted]% fee to any co-managing professionals in accordance with written directions from MD, [redacted], or such other doctor. In the event the manufacturer of the excimer

laser lowers the [redacted] fees below the current $[redacted] per procedure, [redacted] will pay to MD as additional professional fees an amount equal to [redacted]% of the reduction in [redacted] fees with respect to procedures performed by the doctors set forth above.

Your question is whether the gross amount collected under the contracts between the various [redacted] affiliates and the non-employee doctors constitutes gross income to [redacted] for purposes of I.R.C. Sections 61 and 55(e).

DISCUSSION

Issue 1: Gross income

A. The definition of income

I.R.C. § 61(a) defines gross income as "all income from whatever source derived." The language in section 61 is to be interpreted broadly, so that any funds received by a taxpayer should be presumed to be income unless the taxpayer can establish that the funds fit within a specific exclusion in the Internal Revenue Code. Iowa Southern Utilities Co. v. United States, 841 F. 2d 1108, 1111 (Fed. Cir. 1988); James v. United States, 366 U.S. 218, 219 (1961); Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429-31 (1955).

B. The claim of right doctrine

The claim of right doctrine establishes the principle that, if a taxpayer receives income under a claim of right and without restrictions as to its disposition, he has received income and accordingly must be taxed on it. North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932). In order for the claim of right doctrine to apply, two prerequisites must be present at the close of the period within which the income is sought to be taxed. Id. "First, the taxpayer must claim entitlement to the funds at issue. Second, such funds must be held by the taxpayer without restrictions on disposition." Continental Illinois Corp v. Commissioner, 998 F.2d 513, 520-21 (7th Cir. 1993), cert. denied, 510 U.S. 1041 (1994).

Under the first prerequisite, there are a few exceptions in which the claim of right doctrine will not apply. Under the second prerequisite, the taxpayer must establish that he has no right to keep money he receives and, at the time he receives the money, he is obligated to pay that money to another. If this is established, then the taxpayer's receipt of that money will not be considered income. Electric Energy, Inc. v. United States, 13

Cl. Ct. 644, 649 (1987). Thus, the taxpayer is not required to include in his income money received under an express and unequivocal contractual, statutory or regulatory duty to repay it, so that he really is just an agent or custodian of the money. Commissioner v. Indianapolis Power & Light, 493 U.S. 203, 211 (1990); Bates Motor Transportation Lines, Inc., v. Commissioner, 200 F.2d 20 (7th Cir. 1952). Additionally, the taxpayer's obligation to pay the funds received must be fixed and definite at the time the taxpayer received the funds. Bates Motor, 200 F.2d at 24; Indianapolis Power & Light, 493 U.S. at 211.

In Bates Motor, the taxpayer was a common carrier of freight. The taxpayer billed the government for freight at the prevailing rates. However, under its contract with the government, the General Accounting Office was required to examine the taxpayer's bills; if the charges exceeded certain standards, the carrier was required to refund the excess to the government. Thus, there was a definite and fixed obligation to repay the excess income received. Accordingly, the court found that the taxpayer received amounts it was not entitled to and to which it asserted no claim. Therefore, the Bates Motor Court held that the claim of right doctrine did not apply to the amount the taxpayer was required to refund.

[redacted] has no claim of right with respect to the amounts it is obligated to pay to the MD or non-employee doctor. By the express terms of the contract, [redacted] did not have the right to keep [redacted]% of the fees. [redacted] is clearly required to pay a specific portion of the fee to the MD. Thus, [redacted]% of the total gross fee collected under the contracts in question should not be included in the gross income of [redacted]. The gross income of [redacted] should exclude the portion of the fee that [redacted] is contractually required to pay to the MD. This amount constitutes gross income of the MD.

Issue 2: Alternative Minimum Tax

A. Gross Receipts Test:

I.R.C. § 55(a) imposes (in addition to any other tax imposed by Subtitle A) a tax equal to the excess (if any) of (1) the tentative minimum tax for the taxable year over (2) the regular tax for the taxable year. The Taxpayer Relief Act of 1997, P.L. 105-34, enacted an exemption for small corporations which is presently found at I.R.C. § 55(e). Under the Taxpayer Relief Act of 1997, for tax years beginning in 1998, qualifying small corporations will be exempt from the AMT. A corporation will be eligible for this exemption if it has met the $5 million gross

receipts test of I.R.C. § 448(c) for its first taxable year beginning after December 31, 1996. I.R.C. § 55(e)(1).

Thus, with respect to the present case, if the total gross fees collected by [redacted] under the contracts it has with the various MDs constitutes "gross receipts," under sections 55(e) and 448(c), then [redacted] will not be exempt from the alternative minimum tax ("AMT"). However, if the total fees collected are not considered to be "gross receipts," under these provisions, then the average annual gross receipts of [redacted] for the years [redacted], [redacted] and [redacted] will not exceed $5 million and the AMT will not apply to [redacted] for its [redacted] taxable year.

1. Gross Receipts Test under Section 55(e)

Section 55(e)(1)(D) specifically provides that paragraphs (2) and (3) of section 448(c) shall apply in determining average annual gross receipts, for purposes of determining whether the corporation is exempt from AMT. The calculation of average annual gross receipt test was clarified by Congress in 1998.

In 1998, Congress clarified the application of the small corporate exception to the alternative minimum tax. Included in the General Explanation of Tax Legislation enacted in 1998, 105th Congress, 2nd Session; JCS-6-98, was a Technical Correction to the Taxpayer Relief Act of 1997. P.L. 105-206. H.R. 2676, (H. Rept. 105-364, Part I). This technical correction reads, in relevant part, as follows:

TECHNICAL CORRECTIONS TO THE TAXPAYER RELIEF ACT OF 1997

E. Amendments to Title IV of the 1997 Act Relating to Alternative Minimum Tax

1. Clarification of the small business exemption (sec. 6006(a) of the 1998 IRS Restructuring Act, sec. 401 of the 1997 Act, and sec. 55 of the Code)

Present and Prior Law

The corporate alternative minimum tax is repealed for small corporations for taxable years beginning after December 31, 1997. A small corporation is one that had average gross receipts of $5 million or less for a prior three-year period. A corporation that meets the $5 million gross receipts test will continue to be treated as a small corporation exempt from the alternative minimum tax so long as its average gross receipts do not exceed $7.5 million.

Explanation of Provision

The provision clarifies the application of the $5 million and $7.5 million average annual gross receipts tests that a corporation must meet to be a small corporation exempt from the AMT. Under the provision, in order for a corporation to qualify as a small corporation exempt from the AMT for a taxable year, the corporation's average annual gross receipts for all 3-taxable-year periods beginning after December 31, 1993 and ending before such taxable year must be $7.5 million or less. The $7.5 million amount is reduced to $5 million for the corporation's first 3-taxable-year period (or portion thereof) beginning after December 31, 1993, and ending before the taxable year for which the exemption is claimed.

If a corporation's first taxable year beginning after December 31, 1997 (the first year the exemption is available) is its first taxable year (and the corporation does not lose its status as a small corporation because it is aggregated with one or more corporations under section 448(c)(2) or treated as having a predecessor corporation under section 448(c)(3)(D)), the corporation will be treated as an exempt small corporation for such year regardless of its gross receipts for such year.

The operation of the gross receipts tests for the small corporation AMT exemption is demonstrated by the following examples.

Example 1: Assume a calendar-year corporation was in existence on January 1, 1994. In order to qualify as a small corporation for 1998 (the first year the exemption is available), (1) the corporation's average annual gross receipts for the 3-taxable-year period 1994 through 1996 must be $5 million or less and (2) the corporation's average annual gross receipts for the 1995 through 1997 period must be $7.5 million or less. If the corporation qualifies for 1998, the corporation will qualify for 1999 if its average annual gross receipts for the 3-taxable-year period 1996 through 1998 also is $7.5 million or less. If the corporation does not qualify for 1998, the corporation cannot qualify for 1999 or any subsequent year.

2. Definition of "Gross Receipts"

The term "gross receipts" is not defined in section 55. However, section 55(e) instructs taxpayers to look to the gross receipts test of section 448(c). The regulation under 448 does provide a definition of the term "gross receipts." Temp. Treas. Reg. § 1.448-1T(f)(2)(iv) provides, in relevant part:

> The term "gross receipts" means gross receipts of the taxable year in which such receipts are **properly recognized under the taxpayer's accounting method** used in that taxable year (determined without regard to this section) for federal income tax purposes.

3. Application of Gross Receipts Test

In the present case we must apply this definition to an accrual basis taxpayer. When an accrual method of accounting is utilized, an item of income is included in the taxpayer's gross income for the accounting period during which all the events have occurred which fix the taxpayer's right to receive the item of income, and the amount thereof can be determined with reasonable accuracy. Sec. 1.451-1(a), Treas. Reg. § 1.446-1(c)(1)(ii). In determining the taxability of special funds collected from customers, the Seventh Circuit, in Illinois Power Co. v. Commissioner, 792 F.2d 683 (7th Cir. 1986), focused on the fact that the taxpayer had an unequivocal, as opposed to a contingent, repayment obligation. The rule of Illinois Power is that a taxpayer may exclude from his income money received under an unequivocal contractual, statutory, or regulatory duty to repay it, so that he really is just the custodian of the money.

Accordingly, the result reached with respect to this issue is identical to the result reached in issue 1, above. Gross receipts of [redacted] does not include the gross fees collected under the contract. Gross receipts only includes the amount that [redacted] would be required to include in its income under its method of accounting. The facts provided by the examiner state that [redacted] will be exempt from AMT if the term "gross receipts" only includes the net amount that [redacted] ultimately receives under the contract. Based upon this statement, no AMT applies at the present time with respect to [redacted] unless the aggregation rules are found to apply. However, the net receipts of [redacted] for the [redacted] year totaled $[redacted]. Please note that the AMT may apply in future years should the three year average of gross receipts exceed $7.5 million.

B. Aggregation of Gross Receipts

For purposes of computing gross receipts, all taxpayers treated as a single employer under subsection (a) or (b) of Section 52 or subsection (m) or (o) of Section 414 (or that would be treated as a single employer under these sections if the taxpayers had employees) will be treated as a single taxpayer. See Treas. Reg. § 1.448-1T(f)(2)(ii). [redacted] has no ownership interest in any of the MD entities.

Section 52: Single Employer

Under I.R.C. § 52, corporations are treated as a single employer if they are members of the same "controlled group of corporations" as defined in section 1563(a) with certain modifications. I.R.C. § 1563(a)(1), sets forth the definition of a "Parent-Subsidiary Controlled Group." Section 1563(a)(2), sets forth the definition of a "Brother-Sister Controlled Group." Under each definition, among various other requirements, the common entities must own at least 80% of the total combined voting power of all classes of stock entitled to vote.

Section 414

Under section 448(c)(2) all persons treated as a single employer under subsection (m) or (o) of section 414 shall be treated as one person for purposes of the section 448(c)(1) gross receipts test. Section 414(m)(2) of the Code defines an affiliated service group as a group consisting of a service organization (referred to as a first organization) and

(A) any service organization which -

(i) is a shareholder or partner in the first organization, and

(ii) regularly performs services for the first organization or is regularly associated with the first organization in performing services for third persons.

In order to aggregate gross receipts, the Service would have to show that the control test of section 52 is met or that there is an affiliated service group as defined by I.R.C. § 414(m). Since [redacted] has no ownership interest in any of the MD entities, no aggregation of gross receipts is permitted in this case.

If you have any questions concerning this matter, please call Attorney [redacted].

[redacted]

Attorney (LMSB)